Comments

of

TAX EXECUTIVES INSTITUTE, INC.

on

PENDING CANADIAN INCOME TAX ISSUES

Submitted to

THE DEPARTMENT OF FINANCE

DECEMBER 9, 2009

Tax Executives Institute welcomes the opportunity to present the following comments on income tax issues, which will be discussed with representatives of the Department of Finance during TEI's December 9, 2009, liaison meeting. If you have any questions about these comments, please do not hesitate to call either Sherrie Ann Pollock, TEI's Vice President for Canadian Affairs, at 416.955.7373, or Rodney C. Bergen, Chair of the Institute's Canadian Income Tax Committee, at 604.488.5231.

Background

Tax Executives Institute is the preeminent professional organization of business executives who are responsible — in an executive, administrative, or managerial capacity — for the tax affairs of the corporations and other businesses by which they are employed. TEI's 7,000 members represent more than 3,000 of the leading corporations in Canada, the United States, Europe, and Asia. Canadians make up approximately 10 percent of TEI's membership, with our Canadian members belonging to chapters in Montreal, Toronto, Calgary, and Vancouver, which together make up one of our nine geographic regions. In addition, a substantial number of our U.S., European, and Asian members work for companies with significant Canadian operations. In sum, TEI's membership includes representatives from most major industries, including manufacturing, distributing, wholesaling, and retailing; real estate; transportation; financial; telecommunications; and natural resources (including timber and integrated oil companies). The comments set forth in this submission reflect the views of the Institute as a whole, but more particularly those of our Canadian constituency.

1. Status of Pending Legislation

There are a number of provisions in the *Income Tax Act*, *Canada* (hereafter "the Act") where draft legislation has been outstanding for a lengthy period, including the foreign affiliate rules in section 95, the resource successor rules in proposed subsection 67.7(10.1), and the phase-out of accelerated capital cost allowance for oil sands equipment noted in the 2007 Federal Budget. To reduce uncertainty for taxpayers when making business decisions or analyzing the tax treatment of proposed expenditures, we request an update on the Department's agenda for proposed legislation.

Department of Finance Response

The Department of Finance would like to reintroduce the measures that were contained in Bill C.-10, including some form of rules related to FIEs and NRTs. The proposals are currently under review.

The legislation for the last budget was introduced within eight weeks of the budget announcements.

Additionally, the Department of Finance over the past year has spent significant amounts of time dealing with inquiries from the Auditor General's department.

2. Advisory Panel on Canada's System of International Taxation

In December 2008 the Advisory Panel on Canada's System of International Taxation (hereafter "the Advisory Panel" or "the Panel") made numerous recommendations for improving Canada's international taxation system. Many of the recommendations were consistent with comments TEI made to the Panel. We invite the Department to provide an update on its views and analysis of the Panel's recommendations, including whether a potential timetable for implementation of the Panel's recommendations has been developed.

Department of Finance Response

The response to the Godsoe report is ongoing. The anti-double-dip rule contained in section 18.2 has been repealed. The Department is currently in the process of reviewing the 2004 foreign affiliate proposals as well as the FIE and NRT rules. These reviews will be completed before making any further amendments to these rules.

The Department continues to study the report and will be consulting with others as appropriate. Any recommendations contained in the report will be subject to further review before any further amendments are made to the international rules.

3. Non-Resident Withholding Tax

A. *Elimination of Regulation 105 Withholding Tax*

Section 105 of the Income Tax Regulations states that "every person paying to a non-resident person a fee, commission or other amount in respect of services rendered in Canada, of any nature whatsoever, shall deduct or withhold 15% of such payment" and remit it to the Canada Revenue Agency (CRA). The tax withheld is an installment in respect of the non-resident's potential Canadian tax liability.

TEI and others expressed concern about the burdens imposed by Regulation 105 during consultations undertaken by the Advisory Panel. In its report, the Panel observed that the costs associated with complying with the regulation are significant and service providers must commonly gross-up their fees to offset the withholding tax, which can increase costs to Canadian businesses and hinder their ability to engage skilled workers from outside Canada. Moreover, the Panel said that CRA's waiver process is cumbersome and is not used as often as it could be, often because it cannot

be invoked on a timely basis. Finally, the service provider will incur reduced or delayed revenues and cash-flow problems unless the payer indemnifies the service provider with a gross-up payment. After reviewing the costs and benefits of the current system, the Advisory Panel recommended eliminating the withholding tax requirements related to services performed and employment functions carried on in Canada where the non-resident certifies the income is exempt from Canadian tax because of a tax treaty. To aid CRA in enforcing service provider compliance obligations, the payer would be required to submit information reports for payments made to non-residents. We invite the Department's reaction to proposals to eliminate the withholding where the provider certifies its eligibility for treaty-based relief.

As an alternative to eliminating the withholding tax, would the Department consider making changes to the legislation to ease the burden associated with obtaining waivers and otherwise streamline the waiver process? In response to a similar question in the 2008 meeting agenda, the Department said it would be willing to meet with TEI to discuss this approach. We stand ready to meet with the Department and CRA at their earliest convenience.

Department of Finance Response

The Department recognizes the compliance burden imposed by Regulation 105 and has spent considerable time reviewing potential relieving measures. The Department is currently considering the merits of introducing advance registration certification, which would be a single, upfront non-resident application to CRA for a fixed period (e.g., five years).

While this is still under review, it is possible that this may be available only for residents of countries with which Canada has entered into a comprehensive tax information exchange agreement. It should also be noted that this would not change the tax implications for non-residents, but merely relieve them from the withholding provisions of Regulation 105 in respect of payments made to them.

The Department would appreciate feedback on this proposal. TEI agreed to provide input to the Department.

B. *Part XIII Tax*

In June 2009 CRA requested comments on its proposed new declaration process, including the related forms (NR301 *Declaration of Benefits Under a Tax Treaty for a Non-Resident Taxpayer*, NR302 *Declaration of Benefits Under a Tax Treaty for a Partnership with Non-Resident Partners*, and NR303 *Declaration of Benefits Under a Tax Treaty for a Hybrid Entity)*, for the administration of withholding tax requirements under Part XIII of the Act. CRA's initiative is welcome. Recent changes to the Canada-U.S. Income Tax Convention, including the new rules for hybrid entities and the "Limitation on Benefits" clause, have made the determination of a non-resident payee's entitlement to treaty benefits and the application of the appropriate Part XIII tax rate extremely complex.

Where payments are made to unrelated non-residents, the Canadian payer must rely on the non-resident's representations in order to determine the rate of withholding tax. Even though the Canadian payer may have no means of independently verifying the accuracy or completeness of the non-residents'' representations, the declaration seemingly will not shield the Canadian payer against

liability for failure to withhold the appropriate Part XIII tax. Would the Department consider introducing an amendment to the Act to ensure that, absent any evidence of collusion or fraud, a Canadian payer can rely on the representations of the non-resident in determining the appropriate amount of tax to withhold? Specifically, unless the Canadian payer knows or has reason to believe that the non-resident's declaration is false, the withholding should be final as to the payer and no penalties should be imposed on the payer for withholding at the incorrect rate. We invite the Department's response.

Department of Finance Response

The Department did not implement this for section 116 and therefore it may be difficult to justify the treatment only for part XIII withholding. The Department is currently working with CRA on the interpretation of the limitation on benefits clause in the Fifth Protocol to the Canada-U.S. Tax Convention. The CRA will be allowed to consider how it will administer this prior to consideration of any legislative changes.

4. Section 143.3

Proposed paragraph 94(2)(g) will clarify that the issuance of treasury shares by a corporation will be deemed a "transfer of property" for purposes of the non-resident trust rules. We believe the proposed clarification should be applied to other sections of the Act. Consider the following acquisition structure:

Canco acquires foreign target ("ForTarget") by way of a triangular merger, as follows:

a. Canco incorporates a foreign acquisition subsidiary ("ForSub");

b. Canco transfers its treasury shares (the "Canco Shares") to ForSub in exchange for shares of ForSub (the "ForSub Shares");

c. ForSub and ForTarget merge; and

d. The ForTarget shareholders receive the Canco Shares from ForSub during the course of the merger as consideration for their ForTarget shares.

If the issuance of the ForSub Shares is not considered to be a "transfer of property" pursuant to proposed subparagraph 143.3(3)(a)(ii), the tax basis of the ForSub Shares held by Canco would be inappropriately reduced to nil. We recommend that a provision similar to proposed paragraph 94(2)(g) be added to section 143.3 in order to afford greater certainty to taxpayers in the treatment of transactions under section 143.3. We invite the Department's response.

Department of Finance Response

The Department is prepared to recommend an amendment to the legislation as requested, but it may not be exactly the same as in paragraph 94(2)(g). Such a change might be retroactive to November 17, 2005.

5. Part VI.1 tax

Under paragraph 110(1)(k) of the Act, a corporation is entitled to a deduction from income equal to 9/4 of the tax payable under Part VI.1. A proposed change to the gross-up factor to three times the Part VI.1 tax payable was first introduced on December 20, 2002. The proposed gross-up factor was based on a theoretical combined federal and provincial corporate income tax rate of 33 1/3 percent. At an effective rate of 33 1/3 percent the deduction fully offsets the effect of the Part VI.1 tax, but the federal and many provincial governments have, since 2002, announced or implemented further reductions in their respective corporate income tax rates. As a result, a factor of three times the Part VI.1 tax will not afford taxpayers the intended offset relief. Would the Department consider adjusting the gross-up factor to reflect that the combined corporate federal and provincial income tax rates are declining and will be close to 25 percent after 2012?

Department of Finance Response

As indicated in the 2007 Economic Statement, the Department is committed to recommending adjustments to take into account the decline in corporate income tax rates and will do so as soon as time and resources permit.

6. Interaction of Subsections 18(4) and 91(1) of the Act

Consider the following corporate structure and financing arrangement:
Under the thin capitalization rules in subsection 18(4) of the Act, the interest otherwise deductible by a corporation resident in Canada in respect of interest paid or payable on outstanding debts to specified non-residents is disallowed to the extent that such debt exceeds two times equity. Under the defined terms in the Act, the thin capitalization provision can apply to interest on debts owed by a Canadian subsidiary (CANCO) to a controlled foreign affiliate (CFACO) of a Canadian Parent Company

Diagram (see original agenda)

Under subsection 91(1) of the Act, the interest income on the loan from CFACO to CANCO will be included in the computation of the CFACO's Foreign Accrual Property Income (FAPI) and thus included in the income of PARENTCO even though the deduction of the interest by CANCO is disallowed by the thin capitalization rules. In other words, the lack of coordination between the thin capitalization rules of subsection 18(4) and the controlled foreign affiliate regime results in double taxation of the same interest (*i.e.*, inclusion of interest income in the FAPI of PARENTCO with no deduction for CANCO). TEI recommends amending the Act to provide that the restriction on the deductibility of interest under subsection 18(4) of the Act will not apply to interest that is included in the income of a Canadian taxpayer as FAPI. We invite the Department's response.

Department of Finance Response

The Department is aware of the problem and is considering how best to address it. It is uncertain whether the better remedy is to change the FAPI rules or the thin capitalization provisions.

7. Subsection 93(2)

Canadian companies investing abroad typically contract long-term debt (*e.g.*, 30 years) to finance investments in foreign affiliates. In addition, the debt is often incurred in the same foreign currency as the investment in order to provide a natural (or so-called passive) hedge for financial statement reporting purposes.

Where a loss is incurred on a disposition of foreign affiliate shares, the subsection 93(2) stop-loss rules reduce the loss by the amount of cumulative exempt dividends received from a foreign affiliate even where the loss is attributable solely to foreign exchange differences arising between the time of the investment and disposition. At the same time, Canadian companies may be subject to tax on foreign exchange gains realized on repayment of the long-term debt incurred to finance that investment. The February 27, 2004, proposed amendments to subsection 93(2) (hereafter "the Proposals") provide some relief from the potential whipsaw of being taxed on foreign exchange gains on debt incurred while having foreign exchange losses on the underlying investment disallowed, but regrettably the Proposals are too narrow in scope to provide relief in many common situations.

In order to satisfy the Proposals' narrow criteria for relief, a Canadian company must repay its long-term debt in the same year it disposes of the foreign affiliate and refinance the long-term debt at current interest rates. Even if it were possible for a company to refinance its long-term debt under the volatile financial market conditions of the past 12 to 18 months, it would have been very costly. Prepayment penalties and potential premiums on the retirement of debt often make it economically infeasible to prepay long-term debts. In addition, the Proposals do not address the following common situations:

- A loss that occurs on the disposition of an asset that arises solely from currency fluctuations where there is no related capital gain on a foreign currency borrowing or where the foreign affiliate acquisition is only partially funded with debt;
- The long-term borrowing *indirectly* funds a foreign acquisition; or
- The gain and the loss arise in different, but related entities (as occurs in some financing structures).

Questions

1. Would the Department consider preparing an amendment repealing subsection 93(2) as recommended in the September 18, 2003, report of the Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants? By making that change, no foreign currency gains or losses would be recognized by an electing Canadian company on its investments in foreign affiliates; similarly, no gains or losses would be recognized on the foreign currency denominated debt. In addition, such a policy change would be consistent with the new functional currency reporting rules in section 261 where Canadian-resident corporations can elect to use a foreign functional currency as the Canadian tax calculating currency.

2. If the answer to question 1 is no, would the Department consider preparing an amendment relaxing the required integration between subsection 39(2) and the stop-loss rules of subsection 93(2) in one or more of the following ways:

a. By removing the requirement that the disposition of the asset and the retirement of the debt occur in the same year?

b. By suspending (instead of denying) the foreign exchange loss until the related debt is disposed of?

c. By permitting foreign exchange gain and loss realized in different but related companies to offset one another?

Department of Finance Response

The Department believes that subsection 93(2) is a necessary rule. It is aware that section 261 can be used to avoid the result but only if the transactions are all within the same currency. The Department does not believe that the use of section 261 in these circumstances justifies other changes to the Act and there is no need to relax the rules.

As indicated previously, the Department is currently reviewing the 2004 foreign affiliate amendments. Some provisions may or may not be positive and the Department is currently unsure which provisions will be changed.

It is difficult to determine the extent to which a loss relates to foreign exchange. Where the shares and debt are within an internal structure, a taxpayer should be able to dispose of debt and shares at approximately the same time. The Department understands, however, that business or legal issues may prevent a disposition of shares and debt at precisely the same moment, which can create problems where the disposition is close to a year-end. As a result, the Department is considering relaxing the current requirement that both events occur within the same taxation year and instead providing a window period of 30 days before and after the disposition in order to match the gains and losses.

8. Manufacturing & Processing (M&P) Legislation

Even though all taxable income is now taxed at the same rate in the federal return (and many provincial returns), profits from M&P activities must still be separately calculated and reported by eligible taxpayers. Would the Department consider amendment to the Act repealing the provisions relating to M&P profits (and the M&P credit) in order to reduce the burden of gathering and reporting the M&P information on taxpayers' returns? Alternatively, for returns where no M&P tax benefit is claimed, would the Department consider issuing a regulation affording taxpayers the opportunity to check a box on a return form in order to elect out of claiming the M&P benefit and thereby omit making the calculations and reporting the information?

Department of Finance Response

The M&P forms are still relevant for provinces that have M&P rules and for investment tax credit purposes. The Department, however, is prepared to permit taxpayers to elect out of the M&P provisions, if desired. Questions remain about how such an election should work, but the working assumption is that it should be an annual election. This would require a legislative change, which the Department is contemplating.

9. Form T5018

Under subsection 238(2) of the Income Tax Regulations "every person or partnership that pays or credits, in a reporting period, an amount in respect of goods or services rendered on their behalf in the course of construction activities shall make an information return in the prescribed form in respect of that amount, if the person's or partnership's business income for that reporting period is derived primarily from those activities." CRA stated in Document 2006-0202971I7 (November 15, 2006) that the expression "derived primarily from those [construction] activities" should be interpreted broadly and thus includes a real estate developer where more than 50 percent of business income of a real estate developer is derived from construction activities.

Assume a large group of companies that are part of a public company that is not in the construction industry. A subsidiary within the group may offer management and consulting services that include the execution of complex turnkey contracts, which also involves the construction of assets under the supervision and management of another subsidiary of the group. The value of the total turnkey contract is an aggregate of the costs of various subcontractors that must be engaged in order to enable the service provider to construct the asset of the turnkey project. The subcontractors may include engineers, architects, construction companies, and other specialized companies. The value of the turnkey projects managed or supervised by the company responsible for delivering the turnkey project can range from millions to hundreds of millions of dollars and in any one year might represent more than 50 percent of the total revenue generated from these types of contracts.
It would be extremely onerous for a public company (or one of its affiliates) to retrieve, compile, and communicate information necessary to comply with subsection 238(2) of the Regulations. More important, a public company is highly unlikely to pay its subcontractors cash. Would the Department consider revising Regulation 238 to apply to companies of a certain threshold thereby alleviating the administrative burden to which corporations are subject?

Department of Finance Response

The Department has referred this question to the CRA for a response.

10. Subsection 207.5(2) Election

Where a Retirement Compensation Arrangement (RCA) incurs losses on its investments, subsection 207.5(2) permits the RCA custodian to make an election to recover refundable taxes. The election is available where the RCA's portfolio at year end is composed solely of cash, debt obligations, shares listed on a designated stock exchange, or any combination thereof, but is not available if the year-end investment portfolio includes participations in income trust funds or income funds even when such funds are listed on a designated stock exchange.

From time to time, the Department has drafted legislation expanding the scope of various provisions in order to address the proper treatment of income trust funds and income funds. For example, subsection 7(1) was amended in 1998 to replace the term "shares" with "securities." We believe that subsection 207.5(2) should be amended to add income trust funds and income funds to the list of eligible properties for which a subsection 207.5(2) election can be made. We invite the Department's views.

Department of Finance Response

This request is not unreasonable. The Department is currently undertaking a broad review of the RCA rules and hopes to issue technical changes in the not-too-distant future. The proposed change could be incorporated at that time.

11. German Fiscal Unity

Under the *German Corporate Income Tax Act*, the fiscal unity provision (*"Organschaft*") permits a German controlled foreign affiliate (CFA2 in the diagram below) of a Canadian corporation (Canco) to transfer its profit or loss to a German parent company (CFA1 below). For German income tax purposes, the transfer payment is deductible by CFA2 and taxable in CFA1.

Diagram (see original agenda)

When CFA2 earns income from an active business, the income derived by CFA1 from the income transfer payment received from CFA2 is generally deemed to be from an active business under clause 95(2)(a)(ii)(B) of the Act. Under the definition of "earnings" in subsection 5907(1) of the Regulations, such income is included in CFA1's "earnings" from an active business.
Income earned by CFA2 from other than an active business (*e.g.,* a capital gain realized by CFA2 on excluded property) is deemed not to be FAPI under paragraph 95(1). Clause 95(2)(a)(ii)(B), however, would seemingly not apply to re-characterize the transfer payment received by CFA1 from CFA2 as income from an active business because the transfer of such income from CFA2 must be considered *deductible* under Canadian (rather than German) rules in computing CFA2's active income. TEI does not believe that the income transfer payment should be treated as FAPI where it is deductible from income that is not otherwise treated as FAPI. Would the Department confirm that the income transfer payment to CFA1 (income in CFA1) will not be viewed as FAPI and thus not included in the income of CANCO as a result of the allocation of such income to CFA1 under the fiscal unity regime?

Department of Finance Response

The Department was not aware of this problem and is sympathetic to the request. The German payments referred to in the question, however, do not square well with the Canadian rules. The Department is uncertain whether the more appropriate fix is to revise the re-characterization rules contained in Regulations 5907 (1.1) to (1.4) or formulate a new set of rules. There are obviously FAPI and surplus ramifications that also must be considered, but the Department is open to rectifying this issue.

Conclusion

Tax Executives Institute appreciates the opportunity to present its comments in respect of pending income tax issues. We look forward to discussing our views with you during the Institute's December 9, 2009, liaison meeting.

Respectfully submitted,

Tax Executives Institute, Inc.